18 November 2015

FOMC minutes

Outdated due to the strong jobs report – December hike seems very likely

- **The minutes of the 27-28 October FOMC meeting were more or less as expected and thus the market reaction was limited. Due to the very strong jobs report for October we think a December hike is more or less a done deal and thus the FOMC minutes were in fact already outdated even before publication** (see also *Flash Comment US: First Fed hike in December due to very strong job report*, 6 November). Also, the doves seem to support – or at least accept – a hike when analysing their recent speeches after the FOMC's October meeting (see also *Flash Comment US: Doves also appear ready to fly in December*, 10 November).

- The minutes explain that the reason why the FOMC included a sentence stating that it would assess whether it was *'appropriate to raise the target range at its next meeting'* was that both markets and analysts had begun to expect that December was no longer in play. **The FOMC wanted to keep *'policy options open for the next meeting'* as the October minutes say**. A 'couple of members' were concerned that the signal effect would be too strong and that the sentence would be interpreted as a hike was very likely. The sentence was in fact interpreted hawkishly and moved market expectations significantly.

- Another important change in the FOMC statement from October was that the reference that *'Recent global economic and financial developments may restrain economic activity'* was removed. **The minutes reveal that most FOMC members think the domestic part of the US economy has been quite robust to the negative external shock**. That said, a few FOMC members think that *'the downside risks from abroad were still significant'*.

- The minutes repeat the message that *'a gradual increase in the target range for the federal funds rate will likely be appropriate to support progress towards the Committee's dual objectives'*. **The future rate increases would be data dependent, i.e. the FOMC could increase/decrease adjustment speed along the way if data surprises on the upside/downside.**

- **The market reaction following the release was above all very muted.** Pricing in the front of the US curve did not change and reactions longer out on the curve remained within a 1-2bp range closing the day unchanged. Lift-off pricing thus continues being 85% for December and a total of 75bp from now and till end-16.

- As mentioned, we think the FOMC will raise the Federal funds rate target in December from 0.00-0.25% to 0.25%-0.50%. **We expect four additional hikes in 2016 corresponding to a hike every other meeting, i.e. in total five hikes from now until year-end 2016.** This is in line with the latest Fed's median projection from September but more hawkish than market pricing (see previous bullet).

- See overleaf for details in the minutes.

Analyst
Mikael Olai Milhøj
+45 45 12 76 07
milh@danskebank.dk

- Turning to the details in the minutes, the key points are the following
  - **Some FOMC members were worried that the labour market was slowing. The jobs report from October released after the meeting has shown otherwise:** *some participants were concerned that the recent slowdown in employment growth might prove more than temporary, and that improvement in labor market conditions might not continue*.
  - **FOMC less worried about the financial market developments following the market turmoil in August:** *Participants also discussed a range of topics related to financial market developments and financial stability. They noted that volatility in global financial markets had abated since the previous FOMC meeting, with equity prices in the United States largely retracing the declines experienced late in the summer.*
  - **FOMC less worried about the economic outlook abroad:** *Most participants saw the downside risks arising from economic and financial developments abroad as having diminished and judged the risks to the outlook for domestic economic activity and the labor market to be nearly balanced. A few participants, though, noted that downside risks from abroad were still significant.*
  - **For people with interest in the FOMC's theoretical thinking, the FOMC discussed the current level of the so-called 'equilibrium real interest rates' which is *'the level of the short-term interest rates that [...] would result in the economy operating at full employment'*. The staff estimates it around 0% implying that monetary policy is less accommodative than commonly thought at the moment. Uses this as an argument for why future rate increases would be gradual and that the new long-run level for the Federal funds rate is lower than pre-crisis:** *The unemployment rate has declined gradually in recent years, indicating that real gross domestic product (GDP) growth has, on average, exceeded growth of potential GDP, but not by a substantial margin. This outcome, in turn, suggested that the actual level of short-term real interest rates has been below but not substantially below the equilibrium real rate, consistent with estimates that r* currently is close to zero, notably below its historical average.*

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